

**WRITTEN TESTIMONY OF
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BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT
ON REFUNDABLE TAX CREDITS
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INTRODUCTION AND SUMMARY

Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee on Oversight, my name is Steven Miller and I am Deputy Commissioner for Services and Enforcement at the Internal Revenue Service. I appreciate the opportunity to testify on refundable tax credits and the ongoing efforts by the IRS to ensure proper administration of the laws relating to these credits.

The number of refundable tax credits has grown in recent years. A refundable credit, unlike other tax credits, not only has the potential to reduce a taxpayer's tax liability to zero but allows the taxpayer to receive a cash payment of any remaining credit amount. Non-refundable credits simply decrease a taxpayer's liability dollar for dollar. These credits implement important Congressional policies, but because taxpayers do not need to have any tax liability to benefit from refundable credits, these credits increase the scope for unintentional error and abuse.

Although a small number of refundable tax credits have existed in the tax code for many years, the proliferation of refundable credits is a fairly recent phenomenon. The IRS currently administers numerous tax laws related to such credits, including, but not limited to the Earned Income Tax Credit, First Time Homebuyer Credit, Additional Child Tax Credit, Adoption Credit, Making Work Pay Credit and the American Opportunity Tax Credit.

The IRS has a dual mission when it comes to administering refundable tax credits. We must balance the mandate to get refunds to those eligible as quickly as possible with ensuring that the money goes only to individuals who are eligible to receive it.

BACKGROUND

Earned Income Tax Credit

Congress created the Earned Income Tax Credit (EITC) as part of the Tax Reduction Act of 1975, to offset Social Security taxes. The credit has evolved into an important program that now lifts millions of children and families above the poverty line each year. In fact, the EITC has come to be known as one of the most important anti-poverty

programs, specifically because it can be claimed by workers whose incomes are so small that they incur no tax liability.

The EITC experiences a high participation rate (75 percent - 80 percent). In 2009, the EITC was claimed on approximately 26 million returns, and the total amount claimed was more than \$58 billion. The value of this credit can be as high as \$5,751 in 2011 for a taxpayer who has three or more qualifying children. For taxpayers with two qualifying children, the maximum credit that can be claimed is \$5,112. For those with one qualifying child it is \$3,094 and for those with no children, it is \$464.

The credit is taken on “earned income,” which includes wages, salaries and other employee compensation, plus earnings from self-employment. To qualify for the credit, individuals must:

- Have earned income;
- Have a valid Social Security number for themselves and for any qualifying child;
- Have investment income of no more than \$3,150 for 2011; and
- Be a U.S. citizen or resident alien for the entire year for which the credit is claimed.

For a child to be considered a qualifying child, the following tests must be met:

- *Age*: The child must be under age 19 at the end of the year (under age 24 in the case of a student) and younger than the taxpayer (or younger than both the taxpayer and the taxpayer’s spouse if filing a joint return), or the child must be permanently and totally disabled at any time during the year for which the EITC is claimed;
- *Residency*: The child must have lived with the taxpayer for more than half of the year for which the credit is being claimed, although certain exceptions to this rule apply
- *Relationship*: The child must be the taxpayer’s son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, such as a grandchild, niece or nephew. Adopted children also qualify, including those lawfully placed with the taxpayer for legal adoption.

In addition, a claimant cannot be the qualifying child of another taxpayer, and cannot use the “married filing separately” filing status. Additional requirements apply for individuals who do not have qualifying children. The credit initially increases as earned income increases, and then is phased out. Taxpayers whose income exceeds certain thresholds are not permitted to claim the EITC.

The American Recovery and Reinvestment Act of 2009 (ARRA) increased the benefit of the EITC for working families with three or more children for 2009 and 2010. Thus in 2009, those families could receive a maximum benefit that was \$629 more than families with two children could receive. In 2010, Congress extended this increase in the EITC through 2012. The additional amount that can be received in 2011 is \$639. Marriage penalty relief and certain other simplification provisions enacted in 2001 are also scheduled to expire after 2012.

First Time Homebuyer Credit

The First Time Homebuyer Credit (FTHBC) was enacted in July 2008 as part of the Housing and Economic Recovery Act of 2008. Under this law, taxpayers who purchased a principal residence after April 8, 2008 and before July 1, 2009, were allowed a credit equal to 10 percent of the purchase price of the home, but not more than \$7,500. In its original form, this refundable credit served as an interest-free loan to taxpayers that must be paid back over a 15-year period beginning two years after the credit was claimed. The FTHBC phases out for taxpayers over certain income levels.

The FTHBC has been amended by three subsequent tax law changes that crossed tax years and also changed the credit type and amount, the eligibility requirements and the effective dates. ARRA extended the tax credit to home purchases through November 30, 2009, increased the credit amount to \$8,000, and extended timeframes for certain military personnel to claim the credit. For homes purchased in 2009, the repayment requirement was eliminated for any taxpayer who kept the home as a primary residence for at least three years. Taxpayers were also allowed to claim a 2009 purchase on a 2008 return.

In November 2009, the Worker, Homeownership, and Business Assistance Act (WHBAA) extended the tax credit to home purchases through April 30, 2010 (but required buyers to close on the home before July 1, 2010). It authorized a credit of up to \$6,500 for long-time residents who buy a new principal residence. It also increased income limits and extended dates for certain members of the military and certain federal employees serving outside of the U.S. Taxpayers were also allowed to claim a 2010 purchase on a 2009 amended return. In this third iteration of the credit, taxpayers were required by Congress to submit documentation with their claims and the IRS was given compliance tools to automatically deny a claim using math error authority under certain circumstances.

In July 2010, the Homebuyer Assistance and Improvement Act (HAIA) allowed those in a binding contract on April 30th to have an additional three months to close on their home purchase, by extending the deadline from June 30th to September 30th.

As of March 2011, more than 4 million returns have been processed claiming more than \$28 billion in the FTHBC.

Child Tax Credit

The Child Tax Credit (CTC) was enacted as part of the Taxpayer Relief Act of 1997. The law allows taxpayers a credit for each qualifying child under the age of 17. In 1998, the first year after enactment, the maximum allowable credit was \$400 per qualifying child, rising to \$500 the next year. In 2001, Congress increased the maximum credit to \$1,000 per qualifying child. The higher amount is scheduled to expire at the end of 2012.

For a child to be considered a qualifying child, the following tests must be met.

- *Age*: The child must be under age 17 at the end of the year and younger than the taxpayer (or younger than both the taxpayer and the taxpayer's spouse if filing a joint return) during the year for which the CTC is claimed;
- *Residency*: The child must have lived with the taxpayer for more than half of the year for which the credit is being claimed, although certain exceptions to this rule apply.
- *Relationship*: The child must be the taxpayer's son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, such as a grandchild, niece or nephew. Adopted children also qualify, including those lawfully placed with the taxpayer for legal adoption;
- *Support*: The child must not provide more than half of his or her own support;

The taxpayer must also be able to claim the child as a dependent on his or her tax return. In addition, the child must be a U.S. citizen, U.S. national or U.S. resident alien. In contrast to the treatment of the EITC, the Internal Revenue Code does not require a qualifying child to have a Social Security number for purposes of the child tax credit.

In general, the CTC is a nonrefundable credit and phases out over certain adjusted gross income thresholds. However, the taxpayer may be eligible for a refundable amount (the Additional Child Tax Credit, or ACTC) if the amount of child credit for which the taxpayer was otherwise eligible exceeds the taxpayer's tax liability. Taxpayers may claim an ACTC equal to 15% of earned income in excess of \$3,000 up to the value of any otherwise unclaimed amounts in excess of tax liability. Taxpayers with three or more children may claim an additional child tax credit equal to the amount by which the taxpayer's Social Security taxes exceed the taxpayer's EITC, if that amount is greater than the additional child tax credit based on the taxpayer's earned income. After 2012, the ACTC will largely expire. Thereafter, only families that would receive the ACTC under the alternative, EITC-based formula will be eligible for a refundable child credit.

In 2009, \$26.8 billion in ACTC was claimed on 20 million returns.

Adoption Credit

The Adoption Credit was enacted in 1996 as part of the Small Business Job Protection Act. That law allowed taxpayers to take a nonrefundable credit of up to \$5,000 of qualifying expenses paid to adopt an eligible child (\$6,000 in the case of a child with special needs). Congress raised the limit on adoption expenses to \$10,000 in 2001. The Patient Protection and Affordable Care Act of 2010 increased the maximum again, to \$13,170 per adopted child, and made the credit fully refundable for 2010 and 2011. After 2011 the credit reverts back to a nonrefundable credit.

For purposes of this credit, qualifying expenses include reasonable and necessary adoption fees, court costs, attorney fees, travel expenses and other expenses directly

related to, and for which the principal purpose is, the legal adoption of an eligible child. An eligible child must be under 18 years old, or be physically or mentally incapable of caring for himself or herself. The credit phases out above certain income levels. Effective for 2010, the IRS required taxpayers to attach one or more adoption-related documents with the completed Form 8839, Qualified Adoption Expenses that is filed with the taxpayer's return.

In the current filing season, through April 29, 2011, we have received just under 73,000 returns claiming the adoption credit, for a total of \$880 million.

Other Refundable Tax Credits

The Making Work Pay Credit (MWP), enacted as part of ARRA, is a fully refundable tax credit based on earned income, and can be up to \$400 (\$800 on a joint return) in 2009 and 2010. The credit is reduced and begins to phase out at \$75,000 of modified adjusted gross income for single taxpayers and \$150,000 for couples. To receive this credit, a taxpayer must have earned income such as wages, salaries, tips, net earnings from self-employment, and a valid Social Security number. The credit was advanced to taxpayers throughout the year through withholding and then later claimed on income tax returns. More than 100 million taxpayers claimed more than \$50 billion in the MWP credit in 2009. Beneficiaries of Social Security, Supplemental Security Income, Railroad Retirement and Veterans Disability received a \$250 one-time Economic Recovery Payment that reduced the allowable MWP credit amount. Many taxpayers were not aware of the required reduction and IRS had to take actions to correct these returns.

The American Opportunity Tax Credit (AOTC), also created under ARRA, is essentially a modified version of the HOPE Credit for education and can be taken for tuition and certain related expenses paid during 2009 and 2010. The maximum AOTC is \$2,500 per year, and the credit can be claimed for expenses for the first four years of post-secondary education. The HOPE Credit can be claimed only for the first two years of post-secondary education, and its maximum dollar amount is \$1,800. The AOTC is 40 percent refundable, whereas the HOPE Credit is nonrefundable. The AOTC begins to phase out at \$80,000 of modified adjusted gross income (\$160,000 on joint returns). In addition, the definition of "qualified tuition and related expenses" was expanded to include expenditures for "course materials." For this purpose, the term "course materials" means books, supplies and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance. In 2009, the AOTC was claimed on 9 million returns, for a total of approximately \$7.8 billion.

IRS TREATMENT OF REFUNDABLE TAX CREDITS

In administering refundable tax credits, the IRS must deliver the benefits that the legislation provides in the intended time frame, while ensuring that appropriate and prudent controls and filters are in place to minimize errors and fraud. This is not an either/or proposition. We must do both well.

In this regard, the IRS recognizes that there is the potential for both fraud and unintentional errors whenever a refundable tax credit is enacted into law or is modified in some fashion. Our compliance challenge has been made all the more difficult in recent years when in some cases late or retroactive passage of statutory changes require us to meet razor-thin implementation deadlines. In addition, annual changes such as those that occurred with respect to the FTHBC, make it very difficult for the IRS to adequately plan for processing and compliance.

Taxpayer Outreach and Assistance

The IRS is committed to assisting taxpayers in understanding and fulfilling their tax obligations. We also strive to ensure that taxpayers are aware of any tax relief to which they may be entitled. For refundable tax credits, these efforts have resulted in a variety of strategies tailored to the specific tax relief being provided, as well as the expected impacted taxpayer segment. Following are specific examples of outreach activities.

Earned Income Tax Credit. The IRS has developed a robust, multi-year integrated communication strategy that leverages communication channels and marketing to increase usage of the credit.

Along with public service announcements on TV and radio, the IRS is also utilizing social media, including Facebook and Twitter. Our website, IRS.gov, includes a page devoted to information about the EITC, called EITC Central, at www.eitc.irs.gov. This site contains information for both taxpayers and preparers, including a Paid Preparer Due Diligence Training module in both English and Spanish.

On January 28, 2011, the IRS held its fifth annual EITC Awareness Day, generating more than 600 activities to increase EITC awareness and help individuals find free tax preparation. Events included 180 press conferences and news releases, 63 letters to the editor, 148 electronic media postings, including postings on Facebook and Twitter, and more than 270 other local activities. Many of these events were supported by congressional, state and local government officials. At the national level, the IRS reached 1,266 English and 87 Spanish-language radio affiliates throughout the country. EITC Satellite Media Tours in English and Spanish reached more than 1.9 million people.

First Time Homebuyer Credit. Upon enactment of the FTHBC, the IRS undertook significant efforts to ensure that taxpayers were aware of the benefit, in addition to developing new forms and instructions to allow taxpayers to file the claim, and implementing significant compliance programs to ensure that the claims were valid.

We focused outreach efforts not only on taxpayers, but also the return preparer community and industry partners. This included numerous media interviews, press events, podcasts, public service announcements and a national marketing campaign leading to countless news articles in English and Spanish featuring the FTHBC. The

IRS publicized the program's details through a special section on IRS.gov, created YouTube videos in English, Spanish and American Sign Language, and issued numerous news releases. We also sent notices to taxpayers who claimed the \$7,500 FTHBC but who may have actually been entitled to the expanded \$8,000 credit under the Recovery Act, to encourage them to file an amended return to claim the additional benefit.

The IRS conducted extensive education and outreach activities with return preparers who assisted taxpayers claiming the credit. We sought to ensure that preparers understood the FTHBC eligibility requirements to minimize inaccurate FTHBC claims. We made visits to some preparers to explain the new law. We also distributed written materials through our e-news for Tax Professionals email service, and we covered the FTHBC at seminars attended by more than 6,500 preparers during the IRS Nationwide Tax Forums.

Additionally, the IRS held a phone forum in partnership with the Department of Housing and Urban Development's Department of Single Family Housing Planning and Development to educate their industry partners and advocacy group partners on the FTHBC requirements for their clients. These partners spread the information through their own networks

Making Work Pay Credit. As with the FTHBC, the IRS developed and distributed a broad range of related communication products for the media, Internet, partners and taxpayers. Beginning in early 2009, we also held thousands of IRS outreach events where we discussed this credit with partner and stakeholder groups, and we highlighted this credit at our own IRS Open Houses for taxpayers.

For the 2010 filing season, the IRS provided taxpayers with the Making Work Pay Withholding Calculator, in both English and Spanish, to help them determine whether they needed to adjust their withholding to avoid having too much or too little Federal income tax withheld from their pay. A total of 4.4 million taxpayers took advantage of this tool.

Processing of Returns with Credits

In administering refundable tax credits, the IRS takes very seriously the need to prevent erroneous and fraudulent refund claims. To the extent possible, it is important to process returns in such a way that identifies problems at an early stage. Tax returns that contain claims for refundable credits first go through standard processing procedures that we have established for all returns, whether they are filed on paper or electronically. Returns with refundable credit claims are also subjected to various filters during return processing to identify potentially erroneous credits.

Our normal processing for all returns involves matching them with certain pieces of information. Returns are "rejected" and not allowed to enter the system for a number of

reasons. For example, we reject over 1.7 million returns because an invalid or duplicate Social Security number was used.

If a return is accepted, it is sent to our Submission Processing Function. We next determine if math error issues exist. Math error authority under the Internal Revenue Code allows IRS to make adjustments to a return without performing an examination. Absent math error authority, adjustments can only be made through an examination. Math error authority is available for errors in computation, use of incorrect Social Security numbers, claims for more than the statutory limit and several other enumerated items. If a math error issue is identified, an adjustment can be made immediately to the taxpayer's return, reducing potentially erroneous refund claims that could result in an improper payment. The IRS has been given specific, legislative math error authority with respect to several refundable credits. In general, math error authority can help the IRS better administer a refundable credit and reduce improper payments when it allows proactive/pre-refund corrections to erroneous or fraudulent claims. Requiring documentation from taxpayers and disallowing claims when such documentation is not provided is also an effective tool in some cases. However, this approach is most effective when the documentation can be verified using third-party data and the number of claimants is relatively small. It is important to note that electronic filing is preferable because of its efficiency and accuracy and requiring taxpayers to submit documentation, as was the case for FTHBC and the adoption credit, has to date forced taxpayers to submit a paper return that must be processed manually. Thus, in requiring taxpayers to submit documentation, the IRS must recognize the additional burden this places on taxpayers and the IRS.

After being checked for math error issues, returns then go through the IRS' electronic fraud detection system (EFDS). This system is designed to identify schemes and patterns. If a return is flagged in EFDS, it is routed to a group of IRS employees to work during which time the full refund is frozen.

Returns are also sent through the IRS' Dependent Database Process (DDB). This process uses business rules and filters to select cases for examination. Third-party information (e.g., the Federal Case Registry) is used in making these selections. If a return is flagged in this process, the portion of the refund attributable to the flagged issue is frozen.

Later in the process, when information returns filed by third parties are available, matching of tax returns to that data is performed.

Challenges Related to Enforcement of Refundable Credits

There are a number of factors that present challenges to our compliance efforts as they relate to refundable tax credits. As the IRS considers this area and how to deal with the administrative challenges outlined below, it must, as previously stated, consider the trade-off of delaying a proper refund versus preventing an erroneous payment. Many of the credits in this category are refundable because of Congressional intent to get help to

those in need as quickly as possible. The EITC is in this category. Other credits are intended to boost the economy, and unnecessary delay in delivering these refunds is arguably equally counter to Congressional intent. A key example in this area is the FTHBC. The IRS must determine what eligibility verification can reasonably be put in place by balancing the need to provide the refundable credit in a timely manner with the administrative challenges outlined below.

In addition, the IRS must determine whether to take action before or after the refund is issued. Enforcement actions can take place pre- or post-refund. Pre-refund enforcement actions include math error adjustments and examinations. Post-refund enforcement actions also include examinations as well as document matching and criminal sanctions. Obviously, it is much more difficult for the IRS to recover erroneous payments after a refund is issued. However, under the Internal Revenue Code, we have a limited period of time (45 days from the due date of the return) in which to issue a refund before interest begins to accrue to the taxpayer.

Challenges that the IRS faces in the administration of the individual income tax, including the administration of refundable credits include the following.

Complexity. Complexity in the rules governing eligibility for and the operation of certain refundable credits creates challenges for both taxpayers and the IRS. Mistakes in the application of the law cause a significant portion of claims that are made in error. Changes in a taxpayer's personal situation and shifting populations also contribute to this challenge. For example, the eligible population for the earned income tax credit shifts by one third each year.

Lack of Third Party Data. In many cases, the IRS lacks real-time third-party data sources that could be used to verify taxpayers' eligibility. A key example in this area is proof that an individual owned and lived in a house as a personal residence for the 5 consecutive years during the 8-year period prior to the new home purchase, part of the eligibility requirements for one version of the FTHBC. Another example is in the Adoption Credit area where the eligibility rules vary depending on the type of adoption. In many of these areas we have had to require documentation of the events claimed, an inefficient process that to date has required taxpayers to file paper returns and requires the IRS to rely more heavily on examinations to detect errors and fraud.

Timing of Data. Even if data may exist, the IRS is often in the position of having to process returns and determine the validity of a refund before it receives the third party data it needs to match against the return. For example, Form 1098-T, which verifies the eligibility for the AOTC, most often arrives after the processing of the refund.

Hard-to-Detect Fraud. The IRS must confront, on an ongoing basis, refund schemes involving erroneous refund claims. This includes claims made by or on behalf of prisoners and individuals who are not U.S. citizens or residents, as well as schemes involving the use of personal data of deceased persons. The IRS has taken a number of steps this year to reduce fraud in these areas. The problem is particularly acute in the

case of prisoner refunds, and the IRS has developed systems that provide special scrutiny to review prisoner refunds. The situation involving prisoners is not a simple process, because some inmates and their families are legally entitled to refunds, and because the prisoner population is constantly changing. Recent efforts to address the prisoner issues include outreach to the states with the highest prisoner fraud, entering into agreements with states and the Federal Bureau of Prisons so that the IRS can disclose information on prisoner fraud, and increasing the number of prisoner returns that will be reviewed. The Administration's 2012 Budget includes a proposal to require state and federal prisons to provide information to IRS.

Tax Law Changes. The IRS often faces extremely compressed timeframes for implementing a new refundable tax credit law. One example is the effective date ARRA imposed for the FTHBC, which was the date of enactment (Feb. 17, 2009). The ARRA modifications to the FTHBC affected the 2008 returns that were being filed and processed at the very time of enactment. Developing new compliance checks and changing IRS' computer processing systems to implement new checks in the middle of a filing season presents unique and difficult challenges. Such compressed timeframes are unforgiving. They do not provide us adequate time to develop, program and implement a robust and effective compliance strategy. Further, unanticipated implementation needs such as IT system changes, testing, form creation, and other requirements can necessitate resource reallocations that affect the performance of core tax administration programs. Early planning to identify potential problems and allocate sufficient resources, including personnel with the appropriate skills and experience is a critical factor in successfully implementing new legislative requirements.

Cash Payments. Refundable credits allow for overpayments beyond income tax liability, and increase the scope for unintentional errors and abuse to filers who do not have any income tax liability.

As stated, refundable credits trigger administrative issues that should be considered as they are designed. Our experience with the EITC and the FTHBC in particular present a number of illustrative compliance challenges to the IRS.

Earned Income Tax Credit

Fraud and error in the Earned Income Tax Credit (EITC) is a significant problem and is a top priority for IRS. Much of the difficulty in administering the EITC derives from its eligibility requirements. EITC eligibility depends on items that the IRS cannot readily observe, including marital status and the relationship and residency of children with the taxpayer. In many cases, the only way in which eligibility claims can be verified is through taxpayer audits. The percentage of payments made in error is estimated to be between 24 percent and 29 percent. Note, however, that this figure is based on a historical sample of tax returns (rather than current filings) analyzed to estimate the rate of mistake and noncompliance. The IRS is taking a number of steps to reduce the amount of payments made in error. One key component of our efforts to reduce the

error rate is the outreach we do to inform people of eligibility requirements in advance of their filing.

In terms of enforcement, the IRS has a multi-faceted approach that uses a variety of traditional and nontraditional tools. Our current enforcement tools recover or protect amounts approaching \$4 billion annually. These include examinations, math error and document matching.

The audit coverage for EITC is higher than for other individual filers (EITC filers are roughly twice as likely to be examined than other individual filers) and EITC examinations constitute more than 30 percent of all individual audits (protecting approximately \$2 billion). For the past several years, the IRS has planned for approximately 500,000 EITC audits to ensure enforcement resources are applied across all parts of the taxpayer spectrum. Sixty percent of examinations are conducted before issuing the EITC.

Under our math error authority, the IRS automatically adjusts items on a return when we identify math or other statistical irregularities related to the EITC. Last year, using math error authority, the IRS blocked approximately 350,000 improper refund claims.

The IRS also modified its traditional underreporter program to specifically include EITC cases. Through this program, the IRS corresponds with taxpayers in regard to approximately 900,000 potentially improper claims each year.

The IRS recognizes that it cannot sufficiently address this issue by traditional enforcement tools alone and continues to explore alternatives to address noncompliance. The IRS' recent Tax Return Preparer Initiative is expected to have a significant impact on reducing EITC fraud and error. Approximately 66 percent of EITC returns are prepared by paid tax return preparers. The IRS is in the first year of this ground-breaking initiative, which includes requiring registration, testing and continuing education for tax return preparers. The new initiative also brings all return preparers under the ethical rules of Circular 230, which gives the IRS disciplinary tools in the case of preparer misconduct. More than 700,000 tax return preparers have registered this year. New education and enforcement requirements will be aimed at improving the accuracy of EITC returns that paid preparers file on behalf of their clients.

In addition to this new registration and testing regime, the IRS has taken steps to affect return preparer behavior through a series of other actions. Components of this strategy include due diligence visits, preparer investigations, notices and injunctions. Additional criminal enforcement efforts, including "knock and talk" visits and undercover shopping are discussed below.

As part of this strategy, for FY2011, the IRS is conducting 1,000 due diligence visits. In these visits, field examiners visit EITC preparers to verify they are meeting the due diligence requirements that Congress imposed. The Administration's FY 2012 Budget includes a proposal to increase the penalty imposed on paid preparers who fail to

comply with the EITC due diligence requirements. The IRS is also exploring the implementation of a new requirement for paid tax return preparers to file a due diligence checklist with the taxpayer's return when the preparer has assisted the individual in claiming the credit. These changes are expected to markedly reduce the number of improper claims on tax returns prepared by paid preparers.

The IRS continues to explore other new ways to address this issue. In connection with OMB's Partnership Fund for Program Integrity Innovation, the IRS recently began a research pilot to determine if state data can be used to reduce errors and improve the integrity of EITC payments. This pilot will explore whether state data can be used as a reliable indicator of relationship and residency of children to taxpayers. Current efforts also include exploring the use of other third-party data, including information from the Federal Case Registry (the national database used to enforce child support laws) to determine if it can be used to decrease improper claims. Additional studies are also in progress, including a test to see if contacting taxpayers by phone will improve our examination process with respect to EITC eligibility issues.

The IRS will continue to take new steps in reducing the amount of erroneous payments in this area while ensuring that those entitled to the credit are able to receive it timely.

First Time Homebuyer Credit

Administering the FTHBC has posed some of the same challenges we face with other refundable credits: There are numerous eligibility requirements, and the Federal government lacks real-time third-party data sources that could be used to verify taxpayers' eligibility. In addition, the FTHBC rules changed at least annually over a span of years with little lead time. The IRS had to develop a compliance strategy within these limitations.

The IRS faced the challenge of designing a compliance program using the tools available. Originally, the IRS had limited statutory authority for math error to prevent mistakes only in certain situations. In the third iteration of the law, IRS was given expanded authority (including the requirement to include certain documentation) to disallow claims up front in other situations as well.

Even with expanded math error authority, the principal tool available for enforcement of the credit is the examination. After the original credit was expanded, the IRS, with no historical data to rely on, developed screening filters that would identify the highest-risk returns and select them for examination, most before the credit was released. As IRS gained additional experience with the credit, we added new filters and improved those already in existence to increase their effectiveness.

With respect to the FTHBC, the IRS has identified more than 370,000 returns with math errors, conserving exam resources and stopping erroneous refunds from being issued. Through more than 450,000 examinations, the IRS has protected revenue of almost \$1.5 billion. The IRS has also identified more than 200 possible criminal schemes.

Efforts to ensure compliance and prevent abuse can sometimes create burden for both the IRS and taxpayers who legitimately claim the credit. When the law changed to require taxpayers to attach documentation to their returns, it enhanced taxpayer compliance, but the IRS was challenged to manually process paper returns, which is less efficient and accurate than electronic return processing. Some eligible taxpayers were challenged when paper returns were required and processing of their refunds was slowed. Those taxpayers selected for examinations also saw delays in their refunds.

In December 2010 and January 2011, before this filing season, the IRS sent notices to millions of FTHBC recipients. The notices reminded taxpayers who had a 15-year repayment obligation to report the first year of repayment. The IRS also provided information about situations that might cause recapture. In addition, taxpayers for whom third party information indicated a situation that causes recapture were notified that they needed to report it. The notices were a proactive effort to have taxpayers accurately self-report this coming year - to reduce taxpayer burden, as well as IRS burden.

Administration of the FTHBC was challenging in light of its ever changing provisions. Due to the complexity, the IRS experienced some programming problems this filing season on the repayment provisions discussed above which unfortunately caused some delays in processing.

Criminal Actions and Investigations

IRS Criminal Investigation (CI) plays a key role in the IRS' efforts on refundable credits. CI does this both by participating in filing season visits to preparers and by identifying and pursuing refund filing schemes.

CI is involved in a specific program that targets return preparers who file large numbers of EITC or FTHBC returns. The Knock and Talk Visit (KTV) program provides outreach to specific return preparers before the beginning of each filing season. CI and other IRS employees visit preparers who have a history of preparing returns where claims are considered suspect. During these visits, preparers are reminded about the rules and requirements surrounding the credits. These preparers are then monitored throughout the filing season to determine whether there is an improvement in the claims being made on returns filed by these preparers. CI also does a significant number of undercover shopping visits to test the integrity of certain return preparers.

With respect to fraudulent refund schemes, CI has eight Scheme Development Centers (SDCs) across the country whose primary mission is detecting refund fraud, and over the past four years these centers have uncovered numerous schemes involving refundable credits. Once these schemes are identified, the SDCs forward the information to our CI field offices for further investigation. These field offices, in turn, recommend prosecution of refund fraud to the appropriate U.S. Attorney's Office when sufficient evidence is uncovered to support such recommendations. So far in 2011,

recommendations have been made for almost 700 schemes, affecting over 400,000 tax returns.

When the IRS uncovers a refund fraud scheme that involves a refundable tax credit, that scheme is usually one of two types:

- A return preparer files tax returns for clients claiming refundable credits that the taxpayers are not qualified to receive, in order to maximize the clients' refunds; or
- Individual identities, some of which are stolen, are used to file false returns claiming refundable credits to obtain tax refunds.

Schemes that utilize refundable credits most often involve the larger refundable credits, like the EITC and the FTHBC.

In FY 2010, we initiated more than 300 investigations of suspected refund fraud schemes involving refundable tax credits, the majority of which utilized the EITC. We recommended prosecution in 140 of those cases, and obtained 89 indictments.

Some of the successes involving refundable credits include the following:

- An Alabama man was sentenced in March 2011 to three years in prison and ordered to pay more than \$600,000 in restitution to the U.S. in conjunction with a scheme involving 158 false tax returns. This individual fraudulently obtained names and Social Security numbers of individuals and forwarded them to a person who filed the returns of these people without their knowledge. The tax returns falsely claimed the FTHBC and fuel tax credits.
- A Memphis woman was sentenced in March 2011 to nine months in prison and ordered to pay more than \$250,000 in restitution to the IRS in connection with a scheme that involved helping a number of other individuals file tax returns that included false claims for the FTHBC.
- A California preparer was sentenced in November 2010 to more than a year in prison and ordered to pay approximately \$19,000 in restitution for false returns on behalf of her clients. The returns included false claims for the EITC and Child Tax Credit.
- A Connecticut tax preparer was sentenced in April 2010 to 14 months in prison after pleading guilty to aiding and assisting in the filing of a false tax return. The preparer and her employees had filed returns for clients that improperly claimed the EITC and various deductions. IRS audits revealed that they prepared approximately 183 false tax returns resulting in improper refunds totaling more than \$500,000.

Beyond investigating fraud, CI also strives to stop fraudulent refunds before they are paid. Investigative analysts in our SDCs often identify schemes related to refundable

credit fraud where refunds appear to be going to the same bank account, to the same client, or to the same return preparer. In these instances, the SDCs advise the IRS processing personnel that they have discovered fraudulent claims, and request the refunds be stopped.

CONCLUSION

Refundable credits play an important role in fulfilling Congressional policies, but are inherently subject to a number of administrative challenges. As with all aspects of tax administration, in the case of each refundable credit, the IRS must determine the proper balance of taxpayer service and enforcement to ensure that benefit is afforded only to those taxpayers who are eligible. In the 2012 Budget, the IRS proposed the creation of a new refundable credits office. This office is intended to provide added flexibility and capacity around the IRS' ability to ensure pre-refund compliance and combat refund fraud. Our experience with provisions like the Earned Income Tax Credit and the First Time Homebuyer Credit is that the IRS must be able to act quickly upon passage of legislation to protect the public from refund fraud. This includes education, creating compliance strategies, the programming of refund filters, and downstream review of returns on a pre-refund basis. The IRS will continue to explore new ways to ensure accuracy in this area.

Mr. Chairman, this concludes my testimony. I appreciate the opportunity to testify about the IRS' efforts to ensure proper administration of the laws relating to refundable tax credits.